

California Fair Political Practices Commission

MEMORANDUM

To: Chairman Randolph and Commissioners Blair, Downey, Karlan and Knox

From: Holly B. Armstrong, Commission Counsel
Luisa Menchaca, General Counsel

Re: Adoption of Regulation 18728.5 and Amendments to Regulation 18703.3 –
Definition and Reporting of Incentive Compensation

Date: September 12, 2003

Introduction

New regulation 18728.5 and the proposed amendments to current regulation 18703.3 were first presented to the Commission at its meeting on September 3, 2003. The threshold question presented for the Commission's consideration was whether or not it wanted to adopt regulations addressing the reporting requirements of "incentive compensation," which the Commission had most recently addressed in *In re Hanko*, O-02-088 (August 9, 2002).¹ The Commission determined that regulations codifying the *Hanko* Opinion and including disclosure requirements were appropriate, but that the scope of both the disqualification and disclosure regulations should be narrowly limited to the confines of what was intended by the Commission as expressed in its discussion of the *Hanko* Opinion.

Proposed regulation 18728.5 and the proposed amendments to regulation 18703.3 are now presented for adoption, incorporating the clarifications requested by the Commission of both regulations. Staff has attempted to address each of the points raised by the Commission at the September meeting and to clarify those areas identified by the Commission. In addition, this memorandum includes examples of the application of the disclosure regulations for commission income where staff thought such examples would be useful.

Background

The Act requires that the assets and income of public officials which may be materially affected by their official actions be fully disclosed, and in appropriate circumstances, the officials should be disqualified from acting in order that conflicts of interest may be avoided.

¹ Although the Commission has determined that incentive compensation should be reported, the Commission should recall that there have been situations in which the Commission has pierced the first layer to find that a public official had an economic interest in a third party, but did not require disclosure under section 87207, such as in *In re Nord* (1983) 8 FPPC Ops. 6, where the Commission found that a public official who was a limited partner had an economic interest in not only his controlling general partners, but also in "any other business entity in which either Smith or Jones or both act as a controlling general partner or controlling shareholder . . ." Thus, the Commission said, disqualification was required in those cases. However, the Commission did not require that the public official disclose such third parties as economic interests.

(Govt. Code Section 81002(c)².) “Public officials, whether elected or appointed, should perform their duties in an impartial manner, free from bias caused by their own financial interests or the financial interests of persons who have supported them.” (Section 81001(b).)

As was explained in the September memorandum, the regulation was suggested in the context of consideration of the *Hanko* opinion. In *In re Hanko*, the Commission ratified existing advice that incentive compensation received by a board member of a hospital district, Terilyn Hanko, was attributable to the purchaser of her employer’s products, as well as her employer, for disqualification purposes.

In *In re Hanko*, the Commission was presented with a situation in which the member of the hospital board also worked as a marketing representative for a pharmaceutical company, Baxter Pharmaceuticals. As part of her employment, she made marketing presentations to doctors and nurses regarding introductions to and follow-up utilization of various pharmaceutical products made by her employer. In addition to the salary she received from her employer, Ms. Hanko also received a bonus payment based on overall sales of her employer’s products within Ms. Hanko’s territory, calculated using a rather complicated formula, but based entirely on product gross sales performance within the representative’s territory.

The hospital board on which Ms. Hanko sat was in the process of negotiating a multi-million dollar lease with a hospital with which Baxter, through Ms. Hanko, did business. Ms. Hanko was able to determine that approximately \$1,000 of her incentive compensation for the year 2000 was attributable to purchases of Baxter products by the hospital. The Commission concluded that this extra compensation was “incentive compensation” and that the hospital was a source of the incentive compensation to Ms. Hanko for disqualification purposes.

The issue of disclosure of incentive compensation was not decided in the opinion, but staff was directed to investigate the necessity of a regulation regarding the reporting of incentive compensation. In September, staff presented for pre-notice discussion regulations that would both define “incentive compensation” and outline procedures for reporting it.

The regulations have been revised according to the Commission’s comments and direction at its September meeting and are presented here with examples of how the regulations would be applied in various settings, to facilitate the Commission’s review for adoption.

Proposed Amendments to Regulation 18703.3

The only concerns expressed by the Commission regarding the proposed amendments to regulation 18703.3 were with respect to the definition of “incentive compensation” in subdivision (d), which begins on page 4 at line 12 of the regulation.

² All further statutory references are to the Government Code unless otherwise specified.

At line 13, the phrase “which is ongoing and/or cumulative” has been changed to “which is either ongoing or cumulative, or both,” thus eliminating the “and/or” construction that the Commission disfavored. The basic definition (not including the exclusions) of “incentive compensation” has been broken into two sentences, thereby eliminating two sets of the phrase “and which” from what was one very long sentence. At line 15, the phrase “*his or her*” employer has been changed to “*the official’s*” employer. This clarifying change became necessary when the basic definition of “incentive compensation” was broken into two sentences.

Some concern was expressed by the Commission over whether the exclusionary language: “bonuses, the amount of which is based . . . on . . . performance measured against a preset standard or goal,” might be confused in a sales context, where a monetary bonus might be given after a preset sales goal had been reached.

As explained in *In re Hanko*, O-02-088, (August 9, 2002):

“‘Incentive compensation’ . . . differs from ‘commission’ in that it is not based on a specific sale or similar transaction, and differs from a ‘bonus’ in that it is not a singular event, but is ongoing and/or cumulative as sales or purchases accumulate. Thus, the incentive income, like a commission, is ultimately determined based on the conduct of the purchaser in direct response to the efforts of the public official.”

To address the Commission’s concern, because “incentive compensation” is specifically intended to be contrasted with the type of bonus that is a singular event, i.e. an annual bonus based on corporate profits, and not the type of bonus that might come about in a sales environment raised by the Commission, the phrase “for non-sales or marketing activity” has been added as a modifier to the bonus exclusion at lines 17 and 18 on page 4 of the regulation. The phrase “performance measured against a preset standard or goal” has also been eliminated, because once the exclusion is limited to the sales or marketing arenas, this qualifying phrase seems to reach compensation that would not otherwise qualify as “incentive compensation,” and the phrase is no longer necessary.

At line 20, the phrase “but where” has been replaced with “provided that,” as was suggested at the September meeting. On page 5, line 7, the word “personal” has been inserted in subdivision (d)(2), making the phrase “[t]here is direct *personal* contact,” to clarify that officials in supervisory roles would not qualify as having received incentive compensation under the definition in the regulation if the contact with the purchaser was through subordinates, and not personally made by the official.

Proposed Regulation 18728.5

The Commission expressed concerns regarding the clarity of the portion of the regulation dealing with the reporting of commission income. Staff has attempted to address these concerns in the following ways:

An error was discovered in the drafting of subdivision (b)(1), which has been corrected by the elimination of the phrase “from each source” at lines 9 and 10 of this subdivision. An official is only supposed to report the **total** amount of commission income equal to or exceeding \$500 during the period covered by the statement under this subdivision, not the total amount of commission income from each source, as the regulation erroneously stated prior to correction.

Subdivision (b)(2) has been clarified by the addition of the introductory phrase: “If the official reports commission income as a business, in addition to the information reported pursuant to subdivision (b)(1) of this regulation,” prior to the remaining portion of that subdivision.

Some examples of how commission income would be reported under these regulations are attached as Exhibit A.

In Example 1, the public official, Carol Watkins, is a partner in the business entity Realtors 4 You with an ownership interest of greater than 10%, so she reports her ownership interest on Schedule A-2 and income from Realtors 4 You, pursuant to regulation 18728.5(b)(1)(A). In part 2, she reports the gross income she received, which is over \$100,000, pursuant to regulation 18728.5(b)(1). In part 3, she reports the names of each single source of commission income of \$10,000 or more, pursuant to regulation 18728.5(b)(2).

In Example 2, the public official, Thomas Carson, regularly earns commission income through Prime Investments in which he has no ownership interest, so he lists himself as a business entity on Schedule A-2 in part 1, pursuant to regulation 18728.5(1)(A). In part 2, he lists the gross income he receives, pursuant to regulation 18728.5(b)(1). And in part 3, he lists the names of each reportable single source of commission income of \$10,000 or more, pursuant to regulation 18728.5(b)(2).

In Example 3, part-time real estate agent and public official Rudy Jones lists Super Realty on Schedule C, rather than Schedule A-2, because he conducts business through a firm and does not receive commission income on a regular basis. This is pursuant to regulation 18728.5(b)(1)(B). Mr. Jones reports his gross income received, which is between \$10,001 and \$100,000, pursuant to regulation 18728.5(b)(1), and reports Lynda Armstrong as a single source of income of \$10,000 or more pursuant to regulation 18728.5(b)(2).

With the clarifying changes to regulation 18728.5, staff believes that the regulation is more user-friendly and is easier for the public to understand, particularly when used in conjunction with the forms and instructions that accompany the forms.

Conclusion

Staff has attempted to address all of the concerns raised by the Commission in relation to proposed regulation 18728.5 and the amendments to regulation 18703.3. The Commission directed staff not to expand the scope of the regulation to include supervisory employees, and staff was able

to, through a minor adjustment to the regulation, narrow the regulation to exclude supervisory employees, and to clarify the distinction between “incentive compensation” and “bonuses.” In addition, staff clarified the reporting regulation relative to “commission income.”

Therefore, staff recommends that the Commission adopt regulation 18728.5 and the proposed amendments to regulation 18703.3.

Attachments

Regulation 18703.3

Regulation 18728.5

Examples 1-3